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**Republic of Latvia:** Letter of Intent

**Press Release:**  
[IMF Concludes Fifth  
and Final Review  
Under Stand-By  
Arrangement with  
Latvia](#)  
December 21, 2011

December 8, 2011

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## LATVIA: LETTER OF INTENT

Riga, December 8, 2011

Ms. Christine Lagarde  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

Dear Ms. Lagarde:

1. **Our economic program has achieved its main objectives.** After an unprecedented decline, economic growth is resuming, inflation remains under control, and unemployment—although still high—is declining steadily. We have preserved our fixed (narrow band) exchange rate, stabilized the financial sector, and improved competitiveness through declines in wages and prices, productivity improvements, and structural adjustment. We have also lowered our budget deficit, started work on policies that will preserve long-term fiscal sustainability, and introduced significant reforms to improve private debt restructuring, tax administration, management of state-owned enterprises, and to combat the grey economy. These policies will boost Latvia's growth in the medium term, and put us on a clear path towards euro adoption. To maintain our reform momentum, we will continue to work with the Fund towards these goals under Post Program Monitoring.

2. **We remain committed to implementing our economic program.** Since the Fourth Review we have:

- **Comfortably met all end-August performance criteria as well as end-June and end-September indicative targets.** Excluding one-off financial sector costs, we expect to achieve a fiscal deficit of around 4 percent of GDP (ESA terms) in 2011 (Table 1), well below our 4.5 percent of GDP program target.
- **Met most of our financial sector structural benchmarks, though with delay.** For Mortgage and Land Bank (MLB), we hired a sales consultant, prepared a sales strategy, and on November 2 submitted this to the European Commission (although this was originally due end-June). We are soliciting bids for the bank's commercial assets and intend to sign sales contracts with bidders by March 2012. After discussions with stakeholders, we have withdrawn our initial proposal to amend the Civil Procedure Law to address unpaid utility bills, and have instead introduced changes which make it easier and faster for utility companies to pursue their claims.
- **Met most of our fiscal structural benchmarks, and made significant progress towards fulfilling the rest.** We submitted a revised draft of the Fiscal Discipline Law (FDL) to Parliament on December 6, though submitting constitutional amendments to make the law effective will take more time. We have prepared a strategy to improve

management of state-owned enterprises (SOEs), which will be submitted to Cabinet by mid-December; and we finalized a new strategy on Active Labor Market Policies (ALMP). New elections delayed preparation of the menu of options for the 2012 budget and the budget itself, but we plan to submit this to Parliament by December 7, 2011. We will continue to work to improve our tax compliance strategy and to combat the shadow economy and we recognize that more effort is required in these areas.

3. **We will further strengthen our macroeconomic and fiscal policies to lay solid groundwork for our goal of euro adoption in 2014.** In 2012, we will reduce the fiscal deficit to no more than 2.5 percent of GDP (ESA terms), to meet our aims of fulfilling the ECOFIN Council recommendation to correct the excessive deficit position and of meeting the Maastricht deficit criterion. We intend to take measures that will support a low inflation environment in Latvia and help us meet the Maastricht inflation criterion in a sustainable way. These include sustainable and countercyclical fiscal policy, which will be implemented under the umbrella of the FDL, and the medium term budgeting law, which we plan to submit to Parliament no later than six months after the FDL has been adopted. Additionally, we intend to launch reforms that will promote competition, increase price transparency in local markets, and reduce structural unemployment. We will try to avoid further tax increases.

4. **Looking ahead, our new government will implement a series of structural reforms to ensure that Latvia's economy stays competitive and its long-term growth is sustainable. To this end we intend to:**

- Improve the business environment and ensure the efficient use of EU structural funds and adequate access to finance for companies.
- Continue to implement measures to reduce structural unemployment by ensuring better matching in the labor market.
- Continue to reform the education system, to improve the quality and international competitiveness of educational institutions, and to better link higher and vocational education with labor market demands.

5. **In light of our strong performance and the policies outlined in this letter, we request completion of the Fifth Review and Financing Assurances Review under the Stand-by Arrangement.** In late-November, following the discovery of fraud in Krajbanka, we decided to introduce a temporary restriction on all payments (including deposits) in the bank. The operations of the bank were suspended on November 21 and insolvency proceedings are being initiated. We request a waiver for nonobservance of the continuous performance criterion against imposing or intensifying restrictions on the making of payments and transfers for current international transaction, on the grounds that this

restriction was temporary and has now been removed. Given our continued strong financial position, we do not intend to draw the funds available to us in this review.

**6. We authorize the IMF to publish this Letter of Intent and its attachments, and the related staff report.**

## I. MACROECONOMIC FRAMEWORK

**7. The economy expanded vigorously in the second quarter, but the likely slowdown in the world economy poses new challenges.** With private consumption and investment rebounding in the first half of the year, we have revised our growth forecast this year to 4.5 percent. However, the projected stagnation in trading partners' growth later this year and into next year could cause some weakening in exports, domestic confidence, consumption, and investment. Though we hope that the actual outturn will be better, we believe that our macroeconomic framework for 2012 is prudent, and is based on GDP growth slowing to 2.5 percent. Lower exports and the need to import essential goods are expected to push the current account into a slight deficit. While labor market conditions should continue to improve gradually, we project a modest decline in the unemployment rate (ages 15–74), from 15.8 percent this year to 14.6 percent next year. With long-term unemployment more than half the total, skill loss and skill mismatch are a particular concern.

**8. Inflation should decelerate, helped by moderating domestic demand and a reversal of this year's increase in world food and energy prices.** Although CPI inflation this year should average 4.4 percent, in 2012 it should fall to around 2.4 percent. This should be sufficient to meet the Maastricht inflation criteria in mid-2013, although risks remain. We intend to monitor price developments carefully based on our quarterly macroeconomic projections (Table 2), and to take action to promote a low-inflation environment.

**9. Nominal wages have declined and productivity has increased.** As a result, real unit labor costs have fallen although wages have picked up moderately in 2011 partly driven by the increase in the minimum wage. Taking 2000 as the base year, the gap between real wages and productivity that widened considerably during the boom years has closed, providing a boost to Latvia's cost competitiveness. Even though the improvement in competitiveness has stalled somewhat, the real exchange rate has depreciated significantly from its pre-crisis peak. In order to secure further competitiveness gains, we will continue implementing our structural reform agenda, including the measures listed in ¶4.

## II. FISCAL POLICY

**10. We are on track to meet the 4.5 percent GDP fiscal deficit target for 2011 set in the previous LOI.** We comfortably met the end-August performance criterion and the end-June and end-September indicative targets due to stronger than expected direct taxes, and savings in the social budget. We executed all budgetary spending as planned, though we were forced to use all budgetary funds for unforeseen events to support underestimated structural

spending for state family benefits, health care services, and road maintenance. We also allocated extra funds to cover increasing demand for social safety net spending. We intend to use the remaining budgetary space to frontload the fiscal costs associated with the recapitalization of MLB. Additional funds will also be used to recapitalize airBaltic.

**11. We are adopting a 2012 budget which cuts the deficit to 2.5 percent of GDP in a sustainable way, with quarterly projections for revenues, expenditures and the deficit shown in Table 2.** This will be achieved through the following measures, which total L110 million (approximately 0.8 percent of GDP):

- **Revenue (L39 million-0.3 percent of GDP):**
  - Broaden the real estate tax base to: (i) include auxiliary buildings (larger than 25 m<sup>2</sup>), houses and land for religious organizations not used for religious purpose, and parking lots (L0.5 million); and (ii) give municipalities the option of abolishing the 25 percent upper limit on the annual increase in the real estate tax on land (L3.5 million).
  - Broaden the VAT base by applying reverse VAT on scrap metal and construction activities (L5.9 million).
  - Apply a 10 percent withholding personal income tax on sales of scrap metal (L3.7 million).
  - Strengthen the presumptive taxation of small and micro enterprises by ensuring that the general personal income tax regime is applicable to personnel provided by large companies to microenterprises to minimize their tax liability (L2.7 million).
  - Improve tax compliance by: (i) cancelling interest and fines on unpaid taxes to facilitate the collection of those tax claims (L15 million); (ii) reducing the tax-free movement of excise goods on the non-EU border from daily to weekly (L1.5 million); (iii) increase the gambling tax on slot machines and game tables by 15 percent (L2.2 million); (iv) strengthening the regulation of the gambling industry (L0.7); and (v) ensuring higher tax collection by increasing the resources assigned to the State Revenue Service (L1.2 million).
  - Increase the financial stability levy from 0.036 to 0.072 percent (L2.3 million).
- **Expenditures and net lending (L71 million-0.5 percent of GDP):**
  - Cut subsidies and grants for sports and agriculture (L7.5 million).
  - Reduce the grant for Riga International Airport (L0.2 million).

- Reduce local government spending by: (i) further restricting local government borrowing (L20 million), while extending the borrowing capacity to investment projects not co-financed from EU funds; (ii) reduce the share of personal income tax redirected to local government budgets from 82 to 80 percent, while safeguarding transfers to less prosperous local governments and continuing to co-finance 50 percent of GMI benefits through 2012 (L10 million); and (iii) reduce the central government's share in co-financing of housing benefits for local governments from 20 to zero percent from end-April 2012 (L2.5 million).
- Reduce road maintenance costs and subsidies for public transportation providers (L10 million and L5 million, respectively).
- Reduce expenditures at the Ministry of Defense (L6.6 million), the Ministry of Interior (L1.2 million), and the Ministry of Health (L2.7 million), and reduce financing for the National Library to reflect delays in construction (L2.5 million).
- Reduce expenditures at the Ministry of Welfare related to spending on sick leave benefits by: implementing controls to limit the duration of sick leave (L3 million); and (ii) submitting a proposal to Parliament to reduce replacement rates for long-term sickness benefits.
- By end-April 2012, we will prepare a new strategy on public administration. This strategy will, inter alia, normalize the distribution of employees within the unified wage grid based on effective skills-assessment, and introduce central control over the establishment of new posts. We will also prepare proposals to reform the wage grid and make it more fair towards low-paid employees, award best performers and attract highly-skilled officials (e.g. by setting wages for higher positions closer to private sector levels), as well as prepare proposals for a scheme to reward good and excellent performance of public sector employees.
- **We are also taking the following steps in support of spending restraint:**
  - Continue to cap the daily provision allowance for employees of the Ministry of Defense, Ministry of Justice, and Ministry of Interior at the 2011 level.
  - Continue to cap vacation allowances at 25 percent of the monthly wage in state and local governments till 2013.
  - Freeze at 2011 levels compensation payments to landowners engaged in conservation activities till 2013.
- **Our 2012 budget will include the following measures that take effect from 2013:**

- We will: (i) consider lowering existing thresholds for tax rates on residential property with a view to ensure a broadly equal distribution of the housing stock between the three tax brackets; (ii) abolish the 25 percent limit on annual increases in the real estate tax on land (L10 million); and (iii) carry out cadastral reform to properly reflect the depreciation and market value of residential housing.
- By September 2012, we will adopt a comprehensive reform of the state family benefits and social assistance system to improve targeting to the poorest families, and will review tax exemptions for children (potential saving: L10 million).
- We will reform the social safety net system to improve incentives and reduce poverty traps.
- We will: (i) continue to limit the maximum amount of maternity, paternity, parental, unemployment and sickness benefits until the end of 2014; (ii) submit to Parliament a proposal to continue to cap the replacement rate of maternity and paternity benefits at 80 percent starting from 2013. The proposal will be submitted together with 2012 budget (L5.3 million in 2013); (iii) keep in place the ceilings on social contributions for high income earners beyond 2014. This will limit the maximum amount of social insurance that high income earners can receive.
- Sale of EU emission trading permits (L25 million).

12. **We will submit a supplementary budget for Parliamentary approval if the measures included in the 2012 budget are not sufficient to meet our 2.5 percent deficit target (ESA95).**

13. **Beyond 2012, we plan to reduce the ESA deficit towards our medium-term objective.** Given our goal of further deficit reduction, we will not increase spending or cut taxes during 2012 beyond what is envisaged in the budget. Any revenue over-performance will be used primarily to achieve a lower than targeted budget deficit; we will not increase spending beyond levels in the budget except for accelerating the absorption of the EU funds, or for covering additional needs for social safety net or for active labor market policies. A lower budget deficit will limit the amount of adjustment needed in 2013. Starting from 2013, we will comply with the SGP condition of achieving 0.5 percent of GDP improvement in the structural deficit per year as a benchmark, until we reach our medium term objective. Reductions in social insurance allowances (unemployment, sickness, parental, and maternity and paternity benefits) will remain in force. During 2012, we will review the possibility of extending the temporary suspension of indexation of pensions. We will also develop clear remuneration guidelines to make sure that public service remains attractive for well-qualified personnel.

14. **We are redoubling our efforts to strengthen tax administration and combat the grey economy.** In our 2012 budget, we will restrict the frequency with which tax-free goods can be brought through the non-EU border (which should limit smuggling), apply a withholding PIT on scrap metal, and regulate the online gambling industry, to combat the grey economy. We will provide an amnesty for penalties and interest accrued on unpaid taxes (postponed activity from 2010), which should increase the incentive to pay off overdue taxes while requiring a submission of a zero declaration of income and assets. As part of our tax compliance strategy, we will provide sufficient resources and incentives to the State Revenue Service, and increase the share of audit staff and complete more audits. We will raise internal control and ensure strict implementation of standards and administrative, pecuniary and criminal fines within the public sector. While fighting the grey economy is our top priority, we recognize that their revenue yield is uncertain and hard to quantify.

15. **In parallel, we are making efforts to strengthen fiscal discipline to preserve medium-term fiscal sustainability.**

- We submitted the Fiscal Discipline Law to the Parliament on December 6, with an objective of zero general government balance in the medium term. The FDL clearly defines: (i) principles of a counter-cyclical fiscal policy; (ii) a fiscal balance rule as an instrument for a sustainable and counter-cyclical policy; (iii) a debt rule; (iv) transitional provisions, including consistency with the SGP provisions; and (v) escape clauses, moral sanctions, and monitoring and reporting requirements to ensure compliance with the fiscal rules.
- To support the FDL, we will submit to the Parliament constitutional amendments to make the law more effective. We intend to make the purpose of the constitutional amendments clear in the explanatory notes to the constitution. In addition, we have recommended amendments to the “Rules of Procedures of the Saeima” to ensure that the MoF is given adequate time to evaluate all proposals to change the tax laws before voting in the Parliament.
- Within six months of the FDL’s approval, we will submit a medium-term budget framework law to Parliament, so that it comes into force at the latest with the 2014 annual budget. This law will provide a multi-annual framework for our budgeting procedures and, in accordance with the FDL, will set binding expenditure ceilings for 2+1 years on a rolling basis. It will also include a prohibition on raising spending within the year due to over-performing revenues, and limit the possibility of introducing expansionary fiscal measures after adoption of the budget. These measures are aimed at preventing a return to pro-cyclical policies and the fiscal indiscipline that contributed to the economic crisis.
- To ensure that we meet our future deficit targets, we will not launch any new PPPs in 2012 (except concessions when government assumes no risk or liability). We also continue to cap public guarantees at L754 million (the level in June 2009, when the



2009 supplementary budget was passed). If new PPPs are necessary, they should be offset by savings in other areas.

- We are taking steps to limit the impact of Krajbanka's financial difficulties. We are issuing a L200 million state loan to the Deposit Guarantee Fund, to ensure the payout of insured deposits in Krajbanka. If necessary, we will be ready to issue additional state loans to state and municipal institutions that lost financial resources in Krajbanka, to ensure the continuity of these institutions' operations.
- We will reform the governance of SOEs according to our newly developed and approved concept paper, and proceed with orderly privatization of the companies that should not belong to the public sector and sale of minority holdings in companies where public participation is not justified.
- We aim to maximize absorption of EU structural aid, while improving the efficiency of such spending. At the same time, we will keep in mind the additionality principle for the EU funds which states that these funds may not substitute national investment expenditures.
- We will not include in the 2012 state budget a clause allowing an increase in appropriations without Parliamentary approval (0.2 percent of GDP in 2011 budget). At the same time we will keep the budgetary fund for unforeseen events in an amount of L17 million.

16. **We have taken steps to stabilize airBaltic and will ensure that it does not create unexpected fiscal liabilities (we estimate that in 2010 and 2011 it lost L77 million).** We believe that a well-functioning and sustainable national airline contributes to Latvia's economic development. For this reason, we have taken prompt action to stabilize the company and will take further steps to shore it up in a manner consistent with best practice in public financial management:

- We have made a loan of L16 million to airBaltic and the former private shareholder—Baltic Aviation Systems (BAS)—has made a loan of L14 million under a set of contractually-defined conditions. As part of this operation, the company's statutes have been rewritten, new management, board, and council members have been appointed. All creditors related to the financiers have declared that their claims on airBaltic amount to €70 million. These claims are being restructured: half will have a 10 year maturity postponed until after a five year grace period; the other half has a 10 year maturity postponed until the company is profitable for two years in succession.
- We expect to inject a further L41 million together with L37 million from the financiers, both in equity financing, if the following conditions are met: (i) the state of Latvia and the private shareholder have made the initial contribution as described above; (ii) the auditor of the company has submitted an opinion regarding the 2010

- financial statements and BAS subsidiaries have been audited (the auditor's statement was approved in the shareholders meeting on November 28, 2011); (iii) a new business plan that returns the airlines to profitability developed by a consultant of international repute has been approved by the board and council; and (iv) BAS subsidiaries have been consolidated back into airBaltic in accordance to the conditions established in the contract signed with the financiers. This will provide airBaltic with financial resources and managerial skills to reorient its business model, limit expected losses in 2012 to L24 million, and return to profitability in 2013.
- We have put in place safeguards to ensure that the private shareholder delivers on its commitments and that state funds are not misused. More specifically, the state has operational control of airBaltic under the new statutes and at present (December 1, 2011) owns 99.8 percent of the shares of airBaltic, which ensures complete control over the company.
  - We are taking steps to improve governance in airBaltic and prevent it from becoming a future fiscal drain. In order to resolve the situation in the least costly way, airBaltic will settle claims with its creditors and consolidate BAS subsidiaries in a manner that avoids any direct or indirect bailout of the private shareholder. Public funds will not be used to repay debts to the private shareholder or to purchase subsidiaries from the private shareholder. We will undertake a forensic audit of airBaltic and its related companies and if evidence of fraud or any other wrongdoings is found, we will take legal action against the responsible persons. For the sake of transparency, we will make the 2010 and 2011 audits and the shareholder agreement public. If necessary, we stand ready to take further measures to ensure that the state does not support an unviable or poorly managed company.
  - We have taken all necessary steps to notify the European Commission about the planned joint investment with the private shareholder. The investment follows the private investor principle, with public and private shareholders investing in the company jointly and proportionally, and under the same conditions. As a result, we consider this investment to not be state aid as defined by EU state aid legislation. The first investment of L9.9 million took place on November 2.
  - If the financiers fail to inject the second tranche of the agreed financing of L37 million by December 16, 2011 we will: (i) initiate all legal actions foreseen in the contract with the financiers ; (ii) amend the business plan in a way which ensures that no further investments are necessary and there is no impact on the state budget deficit in 2012-2013; (iii) urgently seek an alternative strategic investor for airBaltic; and (iv) take all necessary steps to notify the European Commission about possible state aid issues and consult with EC in order to assure compliance to state aid issues.
17. **Pension reform will support our long-term fiscal goals.** Following our concept paper on pension reform, starting in 2014 we will submit the draft law to increase the early and statutory retirement ages and the qualification period for retirement. In 2012 we will

eliminate the 2006 supplementary pension for pre-1996 working years (extended to all pensioners in 2008) for new retirees and will review the possibility of extending the suspension of pension indexation, while protecting the poorest pensioners. We remain committed to preserving the sustainability of the three pillars of our pension system and to restoring contributions to the second pillar to 6 percent of gross salaries by 2013, provided that the budgetary situation improves in line with our forecast.

18. **Increasing labor market participation, while protecting the most vulnerable members of society, remains our priority.** Our ALMP strategy will guide us after 2011, when the Workplace with Stipend Program expires. This strategy includes training and a new public works program for those who have been unemployed for more than 6 months and who are not entitled to unemployment benefits. We plan to spend up to 0.3 percent of GDP on active labor market policies in 2012, and we will reallocate up to L23 million from the EU structural funds for regional development to the European Social Fund (ESF), and a further L14 million within the ESF towards ALMPs . Given the uncertainty surrounding the economic recovery, we intend to maintain safety net spending at 0.4 percent of GDP and to keep the current social safety net in place, co-funding GMI payments in 2012, and co-financing the housing benefit until end-April 2012. By end-March 2012, we will conduct a study to evaluate our social assistance and, in cooperation with the European Commission and the World Bank, design a scheme which encourages labour market entry while protecting the poor. The new system will be introduced from 2013. We are considering the possibility of introducing tax incentives for firms which create net new jobs, and will also continue to improve our wage subsidy schemes to encourage hiring of the long-term unemployed, while avoiding substitution effects.

19. **We have started the transition back to market financing with a successful Eurobond placement in June 2011.** Our debt strategy will pre-finance the relatively large repayments coming due to official creditors in the coming years. Next year, we plan to issue an equivalent of U.S. dollar 1 billion in new bonds in international capital markets and we will continue to regularly issue short- and long-term domestic debt in accordance with our debt strategy, with a view toward maintaining benchmark maturities along the yield curve and reducing rollover risk. We expect a net increase in domestic borrowing of L100 million. Overall borrowing in coming years will be limited to an amount consistent with continued debt sustainability.

### III. MONETARY AND EXCHANGE RATE POLICIES

20. **Our monetary policy strategy is to maintain the fixed (narrow band) exchange rate until we adopt the euro, and for our main refinancing rate to converge to that of the ECB.** Maintaining monetary and financial stability requires credible policymaking independence. As such, we reaffirm the existing strong institutional and financial independence of the BoL and FCMC as a basis for continued stability. We will also adjust

our policy stance if necessary to ensure monetary conditions in Latvia remain consistent with our fixed exchange rate.

**21. Our exchange of program financing in the market has worked well and will continue in the period ahead.** After selling significant amounts at the beginning of 2011, Treasury foreign exchange sales decreased to around €5 million per week between July and September due to much lower financing needs. In total, through the first week of October, we sold the equivalent of L500 million in foreign exchange. However, sales for the whole year are likely to be higher due to the usual increase in spending at the end of the year. To ensure that Treasury sales are not perceived as discretionary foreign exchange interventions, we will continue to pre-announce the amounts for sale four weeks ahead, and sales will be determined by fiscal financing needs.

#### IV. FINANCIAL SECTOR

**22. We will continue our close supervision of the financial sector and to strengthen banking regulations in line with EU directives:**

- Certain capital requirements related to securitized positions that carry higher risk have been increased. We will also update our legislation to fill the remaining gaps with the European Systemic Risk Board's recommendations on FX lending.
- We are preparing to implement the EU's forthcoming Capital Requirements Regulation (CRR I) which will improve capital quality, ensure sufficient liquidity, and limit banks' leverage. The EU Capital Requirements Directive (CRD IV)—expected to be approved in mid-2012) will be transposed into national legislation to introduce a capital conservation buffer of 2.5 percent of total risk weighted assets in addition to the 8 percent capital requirement set in the CRR. Latvian authorities will be authorized to introduce a countercyclical capital buffer of up to 2.5 percent or higher on top of the minimum capital requirement if there is a need to prevent excessive credit growth. Both capital buffer requirements shall be met by Common Equity Tier 1 capital.
- We will: (i) continue our tight supervision of the financial system, and reiterate our commitment to strengthen banks' capital base, including by waiving the transitional period for capital requirements foreseen in CRR I; (ii) continue to make the utmost use of our supervisory powers under the second pillar of CRD and impose higher capital requirements for banks whose business model is oriented to servicing non-residents that entails additional risks; (iii) draft amendments to the Criminal Law to strengthen responsibility for submission of deliberately distorted or incomplete information to the supervisory authority; (iv) strengthen the FCMC's capacity to conduct forensic investigations, and broaden the mandate of the FCMC's Financial Integrity Division to conduct forensic investigations of financial institutions and ensure their involvement in fit and proper assessments of banks and in issues related

to the prevention of money laundering; and (v) mandate external auditors to perform a reconciliation of correspondent and securities account balances of all banks by December 21, 2012. This audit will include information on the encumbrance of these assets, and an assessment of the necessity to make additional provisions.

- We have increased the emphasis on consumer rights in the financial sector. Following recent amendments to the Law on Credit Institutions, banks have an obligation to review and respond to consumer complaints within 30 days. We have also issued guidelines aimed at improving communication between market participants and their existing and potential customers. A range of measures has also been taken-including a dedicate website called “Customer School” to educate consumers about the most popular financial products and services available in Latvia and their inherent risks.

**23. We submitted our sales strategy for MLB to the EC on November 2, 2011, and have started the process of selling its commercial part:**

- Together with our sales consultant, we have submitted our sales strategy, consistent with the transformation plan submitted to the EC in April. Bundles of commercial assets and liabilities (including all deposit accounts with the exception of a small amount of current accounts related to the disbursement or repayment of development loans) will be sold in a two-stage auction. Originally due by end-June, the sales strategy was delayed due to late hiring of the sales consultant, the unanticipated parliamentary elections, and difficulties in forging a political consensus.
- We have publicly announced our plan to sell the commercial part of the bank. We have already received initial bids that we are currently reviewing, and will sign final sales agreements by end-March 2012.
- While we are committed to sell all assets of the commercial part, we may decide not to sell some commercial assets if we consider bids to be below the value we can obtain by recovering them ourselves. Such assets will be carved out of the remaining development bank and placed in the Latvian Privatization Agency for a more gradual workout (managed by Parex), but only if we are sure this will maximize value to the state.
- In case the assets that accompany the deposits in bundles 1 and 2 are not sold, we will implement a contingency plan (including effective communication strategy) for the orderly divestiture of deposits to limit risks to financial stability.
- After divesting the commercial assets, we intend to merge the development part of MLB with other state institutions to create one development institution (see ¶24)
- Once the commercial parts of MLB have been sold or transferred to the Latvian Privatization Agency, the bank will not be allowed to attract any new private deposits (except for current accounts directly related to the disbursement or repayment of development loans). The FCMC will ensure compliance with this commitment.

24. **We will approve an action plan for the creation of a single development lending institution by mid-2012, with a view to implement it by end-2012.** The development institution will be subject to strict regulation and supervision in line with applicable legislation. This will optimize development lending in Latvia and ensure more effective use of EU funds, including on-lending of concessional funds using commercial banks as intermediaries. The new institution will not be permitted to attract deposits or to lend directly to clients, except for already approved concessional programs (we estimate this at L230 million), or where the lending is: (i) associated with products not offered by the commercial banks or non-bank financial institutions; (ii) dependent on highly specialized knowledge that commercial banks or non-bank financial institutions do not possess; or (iii) of too small volume or too risky to be of interest to commercial banks or non-bank financial institutions. MLB will not start any new direct loan programs until the action plan for the new development institution is approved. We intend to work closely with the EC on implementation of this plan, as set out in the EC SMOU.

25. **We expect to complete the sale of Citadele Bank by end-March 2012.**

- We have started the sale of Citadele Bank and received initial bids for the bank in end-October. Bidder due diligence is currently taking place; we expect to present final bids to the Cabinet of Ministers in mid-January 2012. Sale of the bank should take place by end-March.
- We remain committed to ensuring that none of the former shareholders that were party to the Investment Agreement at the time of the initial government intervention in Parex, or any investors associated with these shareholders, are allowed to participate in any aspect of the Citadele Bank sale. Any potential purchaser of Citadele Bank's assets must be approved by the FCMC and the EC.
- Until the bank is sold, we will make sure that it meets all regulatory requirements (including liquidity) and remains compliant with the EC-restructuring plan.

26. **We will continue the orderly resolution of Parex Bank by removing the banking license and converting it to a special purpose joint stock company (SPV), in order to maximize returns to the state.**

- As an SPV, Parex would not need to meet regulatory requirements such as holding minimum capital, provisioning according to banking regulations, or contributing to the deposit insurance fund, effectively decreasing operating costs. The SPV's management will be directed to conclude the resolution as soon as possible, with specific dates embedded in the SPV's goals. Management remuneration should align incentives with those of the state, namely to maximize recoveries. When making this transformation, we will aim to minimize the risk of legal challenges to the split of the Parex bank into Citadele and Parex. We expect to accomplish this modification by end-February 2012.

- We will make sure that Parex (and the future SPV) continues to dispose of assets in a way that maximizes recoveries and avoids fire-sales. Funds from asset sales will be distributed periodically to State Treasury, to limit Parex's cash resources to its operational needs.
- We will keep Citadele and Parex as two separate entities to maximize the chances of selling Citadele to private investors.

27. **We are pursuing Parex's former shareholders and senior managers for losses they caused to Parex bank and to the state.** A number of civil and criminal court cases—including a claim by Parex Bank for L62 million in losses, and by the Latvian Privatization Agency for breach of the investment agreement—against the former majority shareholders of Parex are underway. We intend to continue to explore all legal avenues for seeking compensation in court from the two former majority shareholders and senior managers for losses caused to the state and to the bank.

28. **We have taken prompt actions to safeguard interests of Krajbanka's clients.** To limit the potential negative impact of developments in Bank Snoras, Krajbanka's parent bank, we initially limited withdrawals to L100,000 per customer per month. Shortly afterwards we suspended the bank's activities because of the discovery of a deficiency of assets in the bank and also a deficiency of own funds due to fraudulent activities. Management of Krajbanka was taken over by FCMC appointed authorized representatives, while a criminal investigation into the actions of Krajbanka's management was launched. To alleviate the burden on the most severely affected customers, including pensioners, withdrawals of up to L50 per day were allowed on 24-26 November. Reimbursement of insured depositors started on November 29 using the bank's liquid assets and resources from the Deposit Guarantee Fund. The guaranteed amount will fully cover the claims of 99.8 percent of Krajbanka's customers. We are initiating insolvency procedures for Krajbanka.

29. **We have withdrawn the proposal to grant priority status in foreclosure proceedings to utility companies' unsecured claims, but remain committed to address the issue of unpaid utility bills.** To that end, we have submitted legislation requiring utility companies to provide written warnings to debtors in arrears for more than 3 months, and to initiate court proceedings if debts remain unpaid for a further 20 days, in order to prevent these debts from becoming unmanageable. Recently introduced procedures for small claims (up to L1500) will make it cheaper and faster for utility companies to recover their debts. We are also reviewing the system of court and bailiff fees to reduce the cost of enforcing claims, and intend to establish a new (privately operated) credit scoring registry (subject to data protection laws) for service providers (including utility companies) not covered by the existing credit registry, in order to improve debtor discipline. Further, we will assess the extent to which the true problem of unpaid utility bills is that of poverty and inability to pay, and will develop safeguards to protect the poor.

## V. OTHER ISSUES

30. **We will continue to place all long-term program funds in special sub-accounts at the Treasury's euro account at the BoL.** Should these program accounts intended for budget support fall by more than EUR 250 million in any 30-day period, the Ministry of Finance will consult with EC and IMF staff. In anticipation of large cash buffers arising from pre-funding of repayments to official creditors, the Treasury will develop a cash management strategy in consultation with the Bank of Latvia and IMF staff.

31. **The Latvian government will work closely with the EC to pursue reforms as specified in our SMoU with the EC,** in particular to improve the business environment and to make more efficient use of EU-cofinanced financial instruments and R&D support programs.

32. **The Cabinet of Ministers will take all necessary steps to ensure implementation of the commitments outlined in this Letter.** However, commitments which the Constitution stipulates are under the purview of Parliament will remain subject to the legislation process and final approval by the Saeima.

## VI. IMF ARRANGEMENT

33. **On top of our previous commitments under the program, we believe the policies described above are sufficient to achieve the goals of our economic program.** Nevertheless, we stand ready to take additional measures needed to keep the program on track. We will consult with the EC, IMF, and other program partners on the adoption of these measures and in advance of any revisions to the policies contained in this Letter in accordance with the IMF's policies on such consultation. In addition, we will supply information the IMF requests on policy implementation and achievement of program objectives in a timely manner.

Sincerely yours,

Valdis Dombrovskis  
Prime Minister

Andris Vilks  
Minister of Finance

Ilmārs Rimšēvičs  
Governor of the  
Bank of Latvia

Jānis Brazovskis  
Acting Chairman  
Financial and Capital Market Commission



Table 1: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, Fifth Review  
(In millions of lats unless otherwise indicated)

	2011												
	Indicative Target			Indicative Target			Performance Criteria			Indicative Targets			
	end-March		Outcome	end-June		Outcome	end-Aug		Outcome	end-Sept		end-Dec	
	Program	Adjusted		Program	Adjusted		Program	Adjusted		Program	Adjusted	Program	
<b>I. Quantitative performance criteria</b>													
Floor on net international reserves of the Bank of Latvia (millions of euros) 1/	-281	-114	788	222	609	918	76	463	1,110	3	390	1,116	-580
Ceiling on net domestic assets of the Bank of Latvia 1/	1,960	1,843	1,184	1,648	1,376	1,257	1,754	1,482	1,156	1,808	1,536	1,160	2,262
Floor on primary non-EU cash fiscal balance 2/ 3/	-123		-35	-52		39	-33		125	-23		161	-69
Ceiling on public guarantees	754		425	754		450	754		453	754		459	754
<b>II. Continuous performance criteria</b>													
Ceiling on accumulation of general government domestic arrears	40		5	40		8	40		9	40		10	40
Ceiling on accumulation of general government external arrears (millions of euros)	0		0	0		0	0		0	0		0	0
<b>III. Staff consultation clauses</b>													
If international reserves fall by more than €500 million in any given 30-day period													
If sub-accounts for program budget support fall by more than €250 million in any 30-day period													
<b>IV. Indicative target</b>													
Ceiling on the general government wage bill 2/	197		186	505		440	635		570	700		635	929

1/ NIR targets will be adjusted downwards/upwards and NDA targets will be adjusted upwards/downwards by the net change in emergency liquidity assistance (TMU ¶6). NIR targets will be adjusted upwards (and NDA targets adjusted downwards) for any non-concessional external debt issued by the government (TMU ¶7).

2/ Cumulative from the beginning of the fiscal year.

3/ Adjusted downwards for additional social safety net spending (TMU ¶13), and adjusted upwards for excess EU funds-related spending (TMU ¶14) and excess net lending (TMU ¶16).

Table 2: Latvia: Quarterly Projections, Fifth Review under the Stand-by Arrangement

	2012			
	end-March	end-June	end-Sep	end-Dec
Real GDP (percentage change, year-on-year)	3.5	2.0	2.1	2.5
Inflation (percentage change, year-on-year)	3.2	1.9	2.0	2.3
Gross international reserves of the Bank of Latvia (billions of euro)	5.3	5.2	5.7	5.3
Primary non-EU cash fiscal balance (millions of lats) 1/ 2/	91	183	372	365
Total revenue and grants (millions of lats) 1/	1375	2829	4137	5450
Total expenditures (millions of lats) 1/ 2/	1340	2727	3901	5561

Source: IMF staff calculations agreed with the Bank of Latvia and the Latvian Ministry of Finance.

1/ Cumulative from the beginning of the fiscal year. Figures based on IMF calculations and methodology.

2/ Excludes net lending.

Table 3. Latvia: Structural Benchmarks

Structural Benchmark	Motivation	Target date	Outcome
<b>Fiscal Policy:</b>			
Prepare a menu of options to achieve the 2012 deficit target.	Fiscal sustainability: A menu of options developed early in the budget cycle will facilitate preparation of the 2012 budget based on high-quality measures.	Mid-August	Partially done with delay. The menu of options was delayed by parliamentary elections. It was communicated verbally to staff during the October mission.
Revise the tax compliance strategy, taking into account recommendations of an upcoming technical assistance mission from the IMF.	Fiscal sustainability: Improved tax compliance will increase revenue and facilitate the achievement of fiscal deficit objectives. Governance: reduce the gray economy.	End-August	Done with delay. The authorities are revising their tax compliance strategy in light of FAD recommendations. It should be completed by mid-December.
Submission of a 2012 budget to Parliament consistent with the goal of convincingly meeting the Maastricht deficit criterion.	Fiscal sustainability: A strong 2012 budget will be needed to convincingly meet the Maastricht deficit criterion and move Latvia toward the goal of euro adoption in 2014.	End-September	Done with delay due to the parliamentary elections. The budget is expected to be submitted to Parliament on December 7.
Complete a strategy to improve management of state-owned enterprises.	Fiscal sustainability: Improve fiscal transparency, reduce fiscal risks, and potentially raise government revenues. Growth: Increase economic efficiency by reducing state involvement in areas that could be served by the private sector.	End-October	Completed
Submission to Parliament of a draft Fiscal Responsibility Law in consultation with the IMF and the EC.	Fiscal sustainability: This will help anchor fiscal policy on a credible path following completion of the program, ensure the sustainability of public debt, and allow for counter-cyclical fiscal policy.	End-November	Done with delay. The Fiscal Responsibility Law was approved by Cabinet on November 29 and submitted to Parliament on December 6.
Prepare an active labour market policy (ALMP) strategy that will replace the WWS program.	Fiscal sustainability: The new policy will allow a transition away from emergency social safety net spending towards more traditional ALMP spending.	End-November	Completed.
<b>Financial Sector:</b>			
Hire a qualified, experienced, and independent sales consultant mobilizing a team of internationally reputable experts to prepare and run the MLB sales strategy.	Financial stability: Stem further erosion in the bank's value and maintain depositor confidence. Fiscal sustainability: Limit the need for continued public recapitalization.	End-May	Done with delay. The authorities hired Blackstone and SEB Enskilda in June to assist in the sale of the commercial part of MLB.
Submit a MLB sales strategy to the EC and appoint a qualified and independent head of restructuring with international experience to oversee the restructuring and sales process.	Financial stability: Stem further erosion in the bank's value and maintain depositor confidence. Fiscal sustainability: Limit the need for continued public recapitalization.	End-June	Done with delay due to the delay in hiring the sales consultant, the parliamentary elections, and difficulties in forging a political consensus. The sales strategy was submitted to the EC on November 2.
Submit amendments to the initial proposal to amend the Civil Procedure Law to Parliament.	Financial stability: The amendments will address a number of concerns with the initial proposal to address unpaid debts to utility companies, including its retroactive character.	End-July	Done with delay. The initial proposal to amend the Civil Procedure Law has been withdrawn and replaced with legislation that requires utility companies to take prompt action to collect unpaid bills.
Sell the commercial part of MLB.	Financial stability: Stem further erosion in the bank's value and maintain depositor confidence. Fiscal sustainability: Limit the need for continued public recapitalization.	Mid-December	Delayed due to a late completion of the sales strategy. Authorities are soliciting bids for the commercial assets, and plan to sell the bank by end-March 2012.